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Fiduciary Adviser Audit Requirements

by Louis S. Harvey

In passing the Pension Protection Act of 2006 (PPA) Congress sought to provide 120 million participants and beneficiaries with quality, cost effective and unbiased investment advice for their defined contribution [401(k)] and IRA investments. The quality, cost effectiveness and lack of bias are accomplished through an annual audit.

As it stands today, the Department of Labor (DOL) estimates that 3 million participants and 13 million IRA investors need advice and are left to fend for themselves or to use intimidating computer systems to make their investment decisions. The social objective of broad availability of quality investment advice runs counter to the goals of the advisers who seek to serve the less than one million top of the pyramid clients. Recognizing this disparity in goals, Congress included fiduciary relief as an incentive to professionals to serve clients with smaller balances.

The Law & Regulations

Congress' goal of making quality, cost effective and unbiased investment advice is addressed by the addition of Section 408(g) to ERISA. On February 26, 2010 the DOL proposed regulations in specific areas of 408(g) to expand this goal to include providers with a conflict of interest and those serving IRA accounts. This article reflects the newly proposed regulations planned to take effect later in 2010.

In 2007, the DOL issued a Field Assistance Bulletin (FAB 2007-01) that provided guidance for one segment of advisers—the unconflicted, level fee fiduciary adviser protections. The regulations for advisers with a conflict of interest and for IRAs remain open because the proposals for these, developed under the Bush administration, were cancelled by the current administration.



Proposed regulations permit level fee adviser arrangements (typically RIAs) as defined in ERISA 408(g) and FAB 2007-01. These level fee advisers need not wait for final regulations and can move forward to take advantage of the fiduciary protection and expand their business model. The larger universe of conflicted advice, which includes mutual fund companies and registered reps, will be required to use an independently certified computer model.

Type of Audit	Goal	Performed By
Financial Audit	Report financial condition to stakeholders consistent with accounting standards.	CPA firms
401(k) Audit	Protect participants' assets from misuse by fiduciaries.	CPA firms with 401(k) expertise
Securities Audit	Achieve compliance with securities laws and regulations.	Broker/Dealers
Regulatory Audit	Deter and detect violations of securities, tax and labor laws.	FINRA, SEC, IRS, DOL
408(g) Audit	Provide quality, cost effective and unbiased investment advice to participants and beneficiaries.	Independent auditor with appropriate technical training or experience and proficiency

The enforcement of the fiduciary adviser statutes and regulations has been minimal since their enactment. The author is aware of no enforcement with respect to IRAs and only one case where the DOL has challenged a level fee fiduciary adviser. The matter was easily settled with an explanation to a DOL field office. This posture is likely to change in 2010, as the DOL has budgeted to add approximately 75 new staff to its enforcement unit in this area and the IRS has appointed leadership in this area.

Audit versus Audit

Quoting from the statute:

“The requirements of [Section 408(g)] are met if an independent auditor, who has appropriate technical training or experience and proficiency and so represents in writing—

- (A) Conducts an annual audit of the arrangement for compliance with the requirements of this subsection, and
- (B) Following completion of the annual audit, issues a written report to the fiduciary who authorized use of the arrangement...”

The use of the term “audit” as the mechanism to achieve quality, cost effective and unbiased investment advice has created confusion in the marketplace since the term is easily confused with other “audits” that have very different objectives.

Examples of these audits and goals are given in the table above.

Who Must Be Audited

ERISA Section 408(g) permits a variety of advisers to qualify to advise participants. These include RIA firms and representatives, bank trust officers and insurance agents. While ERISA does allow broker/dealers and registered reps, these are prevented from providing advice by the limitations of the broker/dealer exemption in the Investment Advisers Act of 1940.

The PPA calls for all fiduciaries who provide advice to ERISA and IRA participants and beneficiaries to undergo an annual 408(g) audit and the DOL has provided guidance only for advisers who are unconflicted (level fee advisers). As mentioned earlier, guidance for conflicted advisers and IRAs is still pending. In the absence of these regulations, investment advice by conflicted advisers and to IRAs remains prohibited, thus 408(g) audits are not yet applicable for those with a potential conflict of interest.

Guidance for unconflicted advisers was provided in FAB 2007-01, in which the DOL excluded previously permitted advisers from the 408(g) audit requirement. This exclusion applies to:

- *Advisory Opinion Nos. 97-15A and 2005-10A.*
The DOL explained that an adviser could provide investment advice with respect to investment funds that pay it or an affiliate additional fees without engaging in a prohibited transaction if those fees are offset against fees that the plan otherwise is obligated to pay.
- *Advisory Opinion 2001-09A (SunAmerica).*
The DOL concluded that investment advice is permitted where the investment funds pay additional fees to the adviser but the advice is the result of methodologies developed, maintained and overseen by a party independent of the adviser.

All advisers serving participants and beneficiaries of ERISA plans, except as noted above, are subject to annual 408(g) audits. Forthcoming regulations are expected to expand the categories of advisers that will require 408(g) audits.

408(g) Audit Requirements

ERISA Section 408(g) defines requirements for compliance to include:

- Investment advice is provided under an eligible investment advice arrangement.
- Fees (including any commission or other compensation) received by the adviser for



investment advice or for the sale, holding or acquisition of any security or other property in the plan may not vary on the basis of any investment option selected.

- The eligible investment advice arrangement is expressly authorization by separate fiduciary.
- Certain specified disclosures are made.
- All disclosures must be made in accordance with securities laws.
- Recipient of advice must direct investments.
- Compensation must be reasonable.
- Terms must be at least as favorable to the plan as an arm's length transaction.
- Disclosures must be written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant.
- Evidence of compliance must be maintained for at least six years.

The DOL has explained in FAB 2007-01 that 408(g) audits are expected to assess compliance with Section 408(g) of ERISA as well as existing regulations, including:

- Prudent selection and periodic monitoring of the advisory program;
- An objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service;
- Avoidance of self dealing, conflicts of interest or other improper influence;
- Taking into account the experience and qualifications of the investment adviser, including the adviser's registration in accordance with applicable federal and/or state securities law, the willingness of the adviser to assume fiduciary status and responsibility under ERISA with respect to the advice provided to participants, and the extent to which advice to be furnished to participants and beneficiaries will be based upon generally accepted investment theories;
- Periodic review of any changes in the information used in the selection of the adviser, including whether the adviser continues to meet applicable federal and state securities law requirements, and whether the advice being furnished to participants and beneficiaries was based upon generally accepted investment theories; and
- Taking into account whether the investment advice provider is complying with the contractual provisions of the engagement; utilization of the investment advice services by the participants in relation to the cost of the services to the plan; and participant comments

and complaints about the quality of the furnished advice.

Preparing for 408(g) Audits

Preparation for the 408(g) audit begins with the selection of an auditor and understanding the audit process. In selecting the auditor, it is important to establish the expertise in ERISA, financial planning, in the securities laws and specifically in meeting the requirements of Section 408(g).

There are a myriad of ways for advisers to comply with Section 408(g) and the auditor should not put rigid and undue restrictions on an adviser's flexibility. It is also important for the auditor to understand and conduct the audit in a way that is consistent with the goals of Section 408(g).

A crucial step in preparing for the first 408(g) audit is a pre-audit that goes through the paces of the formal audit but the results are not available to the public. The pre-audit identifies deficiencies that can be corrected before the formal audit is conducted. In this way, adjustments can be made to practices, agreements, etc., before it is necessary to make the findings public.

Before either the pre-audit or required formal audit is conducted, it is important to notify plan sponsor and participant clients that they will be contacted as part of the process. This notification can be presented as a very positive step that helps the adviser to continually improve and better meet their needs.

Required Documents

The adviser is expected to provide the auditor with a number of documents. Having these documents in good order will shorten and simplify the audit process. These documents are:

- Annual audit disclosure form, providing the framework for the audit;
- Documentation of procedures and systems in use;
- Compensation statements and agreements;
- Certification that adviser is in compliance with FINRA;
- List of participants served during the year being audited;
- Samples of disclosures/notifications used for participants;
- Samples of participant questionnaires and investment recommendations; and
- Other documents or communication used in the advice delivery to participants.

Audit Process

A prudent audit process includes the following steps that test compliance with all ERISA


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and DOL requirements with a minimum inconvenience to the adviser, plan sponsor and participant. These nine recommended steps are:

- Adviser prepares an annual audit disclosure describing the practice and any changes since the last audit. This disclosure provides affirmative answers regarding possible changes that may have occurred since the previous year's audits;
- Auditor analyzes complaints received from plan participants and other employees by plan sponsors or other entities;
- Review of compensation agreements for compliance with the level fee requirement. Each variant of any standard agreements as well as non-standard agreements are examined;
- Test sample of signers of eligible investment advice arrangements to verify fiduciary status. Plan sponsors and other primary fiduciaries are asked to confirm their fiduciary status, the engagement of the adviser and the quality of services provided;
- Test sample of participants to determine receipt of disclosures and services received. Participants served by the adviser are polled to determine if the standard is maintained;
- Evaluate notification/disclosure to determine compliance. Required notifications/disclosures are reviewed for content and understood by typical participants;
- Compare results to peer group. Compensation for services provided are compared to establish reasonableness as required by the statute;
- Examine terms of eligible investment advice arrangement. Eligibility is defined by specific conditions in regulations and the PPA; and
- Random request for delivery of copy of relevant documents. These requests confirm that disclosed practices are in fact being used.

Audit Results

The results of the audit process are put into a preliminary audit report and management letter that is reviewed by the adviser. Adviser feedback is taken into consideration in preparing the final documents. The final audit report must then be delivered to all plan sponsor clients using the adviser's participant services.

Advisers are encouraged to contact plan sponsor clients at the time of the audit report delivery to answer questions and explain any deficiencies that may be reported. 



Louis S. Harvey is the architect of Dalbar's 408(g) audit services. Dalbar's audit practices and technology may be licensed by firms interested in performing 408(g) audits, after the appropriate training and certification.

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